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Statements on Auditing Procedure

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Scope of the Independent Auditor's Review of Internal Control

1. The purpose of this statement is to clarify previous pronouncements relating to the scope of the independent auditor's review of internal control as it pertains to his examination leading to an expression of opinion on the fairness of financial statements. No attempt is made in this statement to consider the scope of reviews of internal control by the independent auditor for other purposes, such as special engagements involving systems surveys, revisions, etc.

BACKGROUND AND DISCUSSION

2. The standard short-form report¹ includes the following sentence:

"Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances."

3. The generally accepted auditing standard relating to internal control is summarized in the standards of field work² as follows:

"There is to be a proper study and evaluation of the existing internal control as a basis for reliance thereon and for the determination of the resultant extent of the tests to which auditing procedures are to be restricted."

¹ Codification of Statements on Auditing Procedure, page 16.

² Generally Accepted Auditing Standards, page 13.

It is generally recognized that as a by-product of this study and evaluation, the independent auditor is frequently able to offer constructive suggestions to his client on ways in which internal control may be improved.

4. In practice, certain questions arise concerning the scope of the independent auditor's review of internal control because of the broad definition set forth in the Special Report on Internal Control issued by the committee on auditing procedure in 1949. The definition reads as follows:

"Internal control comprises the plan of organization and all of the coordinate methods and measures adopted within a business to safeguard its assets, check the accuracy and reliability of its accounting data, promote operational efficiency, and encourage adherence to prescribed managerial policies. This definition possibly is broader than the meaning sometimes attributed to the term. It recognizes that a 'system' of internal control extends beyond those matters which relate directly to the functions of the accounting and financial departments. Such a system might include budgetary control, standard costs, periodic operating reports, statistical analyses and the dissemination thereof, a training program designed to aid personnel in meeting their responsibilities, and an internal audit staff to provide additional assurance to management as to the adequacy of its outlined procedures and the extent to which they are being effectively carried out. It properly comprehends activities in other fields as, for example, time and motion studies which are of an engineering nature, and use of quality controls through a system of inspection which fundamentally is a production function."

5. Internal control, in the broad sense, includes, therefore, controls which may be characterized as either accounting or administrative³, as follows:

- (a) Accounting controls comprise the plan of organization and all methods and procedures that are concerned mainly with, and relate directly to, the safeguarding of assets and the reliability of the financial records. They generally include such controls as the systems of authorization and approval, separation of duties concerned with record keeping and accounting reports

³ In one sense all controls may be characterized as "administrative," even the accounting controls. The division being made here is for the purpose of distinguishing the accounting controls, with which the independent auditor is primarily concerned, from all other controls.

from those concerned with operations or asset custody, physical controls over assets, and internal auditing.

- (b) Administrative controls comprise the plan of organization and all methods and procedures that are concerned mainly with operational efficiency and adherence to managerial policies and usually relate only indirectly to the financial records. They generally include such controls as statistical analyses, time and motion studies, performance reports, employee training programs, and quality controls.

The extent to which organizational plans and control methods and procedures may be classified as accounting controls or administrative controls will, of course, vary in individual circumstances.

CONCLUSIONS

6. In the ordinary examination, the selection of auditing procedures, their timing, and the determination of the extent to which they should be followed will depend largely upon the auditor's judgment of the adequacy and effectiveness of the internal controls. This judgment is arrived at as the result of his study and evaluation (which may involve testing, observation, investigation and inquiry) of those internal controls which, in his opinion, influence the reliability of the financial records. In the course of his examination the auditor obtains appropriate knowledge of his client's organization and operations, on which he bases his selection of the internal control areas he proposes to evaluate. Accounting controls, as described in paragraph 5(a), generally bear directly and importantly on the reliability of financial records and would, therefore, require evaluation. Administrative controls, as described in paragraph 5(b), ordinarily relate only indirectly to the financial records and thus would not require evaluation. However, if the auditor believes that certain administrative controls, in a particular case, may have an important bearing on the reliability of the financial records, he should consider the need for evaluating such controls. For example, statistical records maintained by production, sales or other operating departments may be considered by the auditor as requiring evaluation in a particular instance.

7. The committee has considered whether the part of the definition of internal control concerning the safeguarding of assets and the auditing standard concerning study and evaluation of internal control, taken together, are inconsistent with the statement in the Codification⁴ to the effect that, in the ordinary examination, the auditor does not assume responsibility for the detection of defalcations and other similar irregularities. The committee sees no conflict in this regard since the objective of the audit program (which is designed, in part, as a result of the evaluation of internal control) is to provide a basis for the expression of an opinion on the financial statements, taken as a whole, and not to detect defalcations or similar irregularities. In developing such a program, the auditor has a responsibility for evaluating internal controls designed to safeguard assets, and when such controls are weak or lacking his program should take this condition into consideration. This consideration might lead either to the extension of audit tests, or to the shifting of emphases or timing of the audit procedures; for example, counts, reconciliations, confirmations, or observations of certain assets (such as cash, receivables or inventories) might be made at the balance-sheet date rather than at an interim date.

⁴ Codification of Statements on Auditing Procedure, "Responsibilities and Functions of the Independent Auditor," pages 11-13.

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